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USDOC FOR ITS/TD/ENERGY DIVISION  
TREASURY FOR IA (RACHEL JARPE)  
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STATE PASS TO USTR (EISSENSTAT/MELLE)  
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SUBJECT: MEXICO STOCKS DROP, PESO WEAKENS AFTER HOUSE BAILOUT VOTE

¶1. SUMMARY. The IPC, Mexico's stock market index, plummeted on Friday Sept. 31, despite the approval of a financial bailout by the U.S. House of Representatives. The IPC plunged 4.32% on Friday, totaling a 10.2% weekly decline, one of the worse performances since ¶2000. The peso also fell to 11.21 to the dollar. Economists agree the country's main sources of foreign currency, i.e. oil, remittances, foreign direct investment (FDI), and manufacturing exports will suffer the most. Economists say FDI is unlikely to reach 2007 levels. Remittances are already down over 12% yoy (year over year). Nevertheless, the Finance Minister has maintained that Mexico's fundamentals are solid, that public finances are healthy and foreign debt represents only 4.2% of GDP. Despite some worry over credit card debt, Mexico holds very little in the way of mortgage-backed securities. In addition, mortgages in Mexico are issues under stricter conditions. The challenge for Mexico will be how to expand financial access and banking services necessary for growth in an otherwise sluggish economy. END SUMMARY

¶2. The IPC, Mexico's stock market index, plummeted on Friday Sept. 31, despite the approval of a financial bailout by the House of Representatives. The IPC plunged 4.32% on Friday, totaling a 10.2% weekly decline, one of the worse performances since 2000. The peso also fell to 11.21 pesos to the dollar in retail operations. The Bank of Mexico's exchange rate closing the week at 11.11 pesos to the dollar. The risk premium closed the week at 258 basis points, 24 basis points up from the previous week. Paradoxically, international reserves kept growing and stood at US\$83.5 billion.

¶3. Mexican authorities and the private sector have generally acknowledged that the U.S. recession will have a negative impact on Mexico's economy. Economists we have spoken to say the country's main sources of foreign currency, oil, remittances, FDI, and manufacturing exports will suffer the most. Observers say lower economic growth and demand will likely push oil prices down. The Finance Secretariat's US\$80.3 per barrel oil reference price projected in the 2009 budget seems already too high, with the Mexican oil mix closed at \$83.8 per barrel last week. The optimistic view among economists we spoke to is that FDI will only reach US\$ 20 billion this year, compared to the US\$ 25 billion received in 2007. Exports have grown slightly, 5.6% yoy. However, this figure is largely due to high oil prices. Actually, manufacturing exports fell 3.8% yoy in August.

CARSTENS SAYS FUNDAMENTALS SOLID

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14. Although the plan approved by the U.S. Congress sends a positive message to the Mexican market about the USG's support for the U.S. financial system, Mexican investors are concerned about the time it will take for markets to see its effects, as well as the length and depth of the U.S. economic recession and its impact on the Mexican economy. Trying to smooth investors' concerns, Finance Secretary Agustin Carstens stated on several occasions that the Mexican government remains prepared to respond to the crisis, and that the country's strong economic fundamentals and solid financial institutions will help Mexico face the economic downturn. He said public finances are healthy, foreign debt represents only 4.2% of GDP, inflationary pressures are under control due to the government's monetary policy and those pressures are expected to recede soon.

#### IMPACT ON INFRASTRUCTURE?

15. The current economic situation will likely impact negatively on one of the countercyclical tools that was supposed to stimulate the economy, the National Infrastructure Plan (NIP). The NIP, announced with great fanfare last year by President Calderon, includes plans for domestic and foreign investment in airports, ports, bridges and highways. It was slow to take off due to bureaucratic obstacles. The private sector now fears that with the financial crunch, business will be unable to obtain the financing to launch the projects. In an attempt to keep the economy on track, Guillermo Zamarripa, the Head of the Banking and Savings Unit of the Finance Secretariat, publicly asked bankers to keep on lending.

#### NO ALARMS OVER MORTGAGES

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16. Regulators and financial authorities have not sounded any alarm bells about overdue mortgage payments. The non-performing housing loans ratio in Mexico is currently only 3%. Mexican mortgage-backed securities, called BORHIS by their Spanish acronym, are structured differently than the troublesome U.S. instruments. Other significant differences between U.S. sub prime mortgages and Mexican mortgages are that all housing loans in Mexico are at fixed rates and require a minimum 20% down payment. Moreover, most of the financial institutions include unemployment insurance policies in the cost of the loan. Since the 1995 "Tequila" crisis, loan origination criteria for mortgages has become considerably stricter. The Bank of Mexico's Governor Guillermo Ortiz confirmed last week that Mexican banks had not acquired any of the toxic instruments that caused problems in the U.S. In Mexico, the only contagion will likely be felt in the very small number of issuances of mortgage-backed securities, which could have a negative impact on housing developers and some non-bank financial institution (sofoles). Mexico has a current demand of around 5 million houses.

#### CREDIT CARDS NEXT?

17. There is concern in Mexico about non-performing credit card loans, where the ratio currently stands at 7%. Since interest rates in credit cards are already high (around 34%) and variable, analysts are concerned about the impact that a deep economic deceleration could have. Banks have reportedly begun to restrict the issuance of credit cards. They have also implemented financial education programs beginning with larger debtors to show them how to make the best use of their credit cards and loans. Most banks have also increased their reserves and their capitalization index, which is currently more than 16%. The challenge for Mexico will be how to expand financial access and banking services in a sluggish economy without deteriorating loan portfolios and credit origination criteria.

#### REMITTANCES ALSO DOWN

18. The Bank of Mexico reported last week the worst decline in remittances ever since the central bank began keeping record of them. In August, remittances fell 12.2% year over year. The unemployment in the construction and manufacturing sectors has hit harder on Mexicans, who are unable to send money to their families.

Some are beginning to worry about a massive return of Mexicans. Given the low job creation in Mexico, it would be impossible to absorb this additional workforce in the formal and informal economy.

GARZA